CONCRETE THOUGHTS

New York: Tax Capital of the Nation

There has never been a period in which the relationships between politics, economics and real estate have been more closely tied.

Robert Knakal

The New York City commercial real estate investment sales market is on fire. Demand is outpacing supply by a wide margin, and historically low interest rates have provided the rocket fuel for a seller's market unlike anything we have seen since 2006-2007.

Almost all product types in all neighborhoods have seen average prices per square foot recently exceed the peaks achieved during the last cycle.

The one notable exception is Midtown office buildings, a fact that sends a very profound message. I have been writing since late 2007, and in that time there has never been a period in which the relationships between politics, economics and real estate have been more closely tied. Poor economic policy and policy overreaction to the great recession have created a broader economy that is simply limping along. Coming out of a recession as deep as the one we recently suffered should result in gross domestic product growth of up to 6 percent annually. We have been at less than one-third of that.

More than any other decision-makers in our commercial real estate sector, this reality is impacting corporate decision-makers who are trying to make office-space decisions.

Some forecasters pooh-pooh this reality, pointing to record corporate earnings, an equities market that hits new record highs day after day and a commercial property sales market that is booming. But consider the facts: corporate profits are at an all-time high, but only because companies have cut expenses (mostly payroll) to the bone. The government has manipulated the interest rate environment to both stimulate the housing market and to keep the nation's interest payments to a minimum. (Imagine what the deficits would look like without near-zero interest rates!) These low interest rates are why the equities markets have rallied the way they have. The commercial property sales markets have been rolling along because historically low yields on income-producing properties have seemed attractive relative to alternative investments and the residential end-user market has been incredibly strong.

But what about office buildings? Why have they been lagging other property types even as corporate profits have reached all-time highs and $2 trillion in capital sits on corporate balance sheets?

Some folks point to the way office tenants are using space today. Some say that technology has changed the paradigm of the office user. While there may be some validity to those points, uncertainty and the perception of an apparent growing trend of anti-business sentiment are probably the most impactful reasons.

On a national level, the health care law has decision-makers feeling like costs will increase by even greater margins than they did before. The lunacy of anyone believing that an additional 33 million Americans could be insured and costs will go down has already proven to be a farce. And Dodd-Frank regulation has already had a tangible negative impact on the financial services industry, disproportionately impacting Gotham. The full impact of these programs has not yet been felt.

Locally, the governor said while campaigning that "New York has no future as the tax capital of the nation." Notwithstanding that taxes today are lower than they were three years ago, they are only very marginally lower, and higher than they are supposed to be. Had the "millionaire's tax" (hardly impacting only millionaires) been allowed to sunset as scheduled, it would have helped. However, this tax on New York's high earners is projected to raise $500 million in 2014 and about $2 billion in 2015. Even with these large revenues, budget deficits are still tangible in these years and bring the top tax rate for those who live in the city close to 60 percent. These folks will have to work until August 5 each year just to pay their taxes.

New York has the highest total tax rates in the U.S. Our total cost of doing business is 47th out of 50, as is our ranking on the list of business-friendly states. Local politicians point to the positive job-creation numbers in the city, but studies show that the jobs being created are low-paying, while those earning higher salaries are moving out. A recent report by United Van Lines shows New York as ranking in the top five for outbound locals. Layer on top of this a new mayor who is likely to be less business-friendly than Mayors Giuliani and Bloomberg, and it is not hard to understand why fundamentals are the way they are in the office leasing sector.

Don't get me wrong, I believe New York is the greatest city in the world, but there is only so far policy can go against folks before they head for the hills. The governor was right when he said that New York has no future as the tax capital of the nation.

Too bad no one is doing anything about that.

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THE LEAD INDICATOR

Girding for Growth in Midtown

The drag of aging properties will worsen over time. So it's no surprise Bloomberg is working to clear development hurdles now.

Sam Chandan

There are good reasons to envisage a refresh of Midtown Manhattan's office inventory.

A prolonged lull in construction has left us with an abundance of heirlooms but few modish buildings. As a global center of finance, Midtown East's built environment compares especially poorly with its peer markets. Average rents are much higher in London, but the premium over Midtown is less pronounced when comparing our small basket of best apples with theirs. Rezoning with an eye to new construction has its winners and losers. As new properties come online over the next decade, incumbents saddled with older buildings may find their highest and best use takes them outside the office sector altogether.

We're not in trouble yet. Aging inventory leaves the country's largest agglomeration at a competitive disadvantage with regard to other global centers, but this shortfall does not yet define the ranking order of business capitals. Unless the financial industry's priorities have changed, caps on bonuses in London and Frankfurt will drive more location decisions than the nettlesome columns that portion floorplates in Midtown. Investors from abroad have cast their vote for New York, targeting core assets even as prices have inched past pre-crisis peaks.

Even on a local level, the rise of Midtown South points to other factors at play alongside space quality, at least in the high-tech sector if not finance. A singular focus on newness and quality would hamstring Midtown on the global stage and in local competition. Businesses would flee en masse to lower Manhattan, which finds itself on the cusp of its second bloom, and with lower market-clearing rents at that. Firms are certainly moving Downtown, and lower Manhattan will soon boast several infrastructure advantages. But the space is only one part of the business production function; Midtown competes rather effectively along other dimensions.

Even if it has offsets in the present, the competitive drag of aging properties will worsen over time. So it's no surprise that a far-sighted mayor is working to clear development hurdles while he can still exert sway over the politics involved. For Midtown East, the process is moving at an unusually brisk pace. Complacency will not be well-rewarded, even if its opposite risks marginalizing the less well-heeled.

Rezoning to higher density in Midtown East is not an end in itself. As a means to an end, however, tradable air rights and the potential for larger buildings on expensive land afford higher returns to developers. All else being equal, investment in new properties will rise as restrictions on scale are relaxed, even if that means higher market vacancy rates. In a well-crafted regime, private returns will be sufficiently high that developers can also fund their share of required public infrastructure.

Whether in Midtown East or any other market, properties that come online will invariably exhibit greater energy efficiency than their grizzled neighbors. The overall demands on the power grid won't fall, but the distinction between buildings that are green and those that are not is increasingly consequential for investors. To restate a proposition from a year ago: buyers will opt unequivocally for the green building when choosing between two properties that are otherwise undifferentiated. As transaction activity has accelerated, a cursory review of the data suggests the value placed on being green has momentum independent of energy costs.

If being green is an advantage, its absence is an increasingly glaring defect. There are measurement issues that confound the analysis, principally as relates to the way greenness is measured and why developers opt to certify, but the trend clearly shows certification as the norm for new institutional-quality assets. That holds a cautionary note for would-be buyers in any neighborhood girding for growth. If the asset you covet is not green and does not lend itself to retrofitting, the discount it already commands will grow wider as its illiquidity becomes more pronounced.

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